APPENDIX A

Internal Revenue Code of 1939

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 of a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) Prima Facie Evidence.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business

shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) Definitions.—As used in this chapter—

(1) Section 102 net income. — The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117(e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23(s), minus the sum of—

(A) Taxes. — Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc. contributions. —Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23*(o)*, for the purposes therein specified. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23(q) as made within such year.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(D) Long-term capital gains.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income.

(2) Undistributed section 102 net income. — The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27(b), but the computation of such credit under section 27(b)(1) shall be made without its reduction by the amount of the credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(e) Tax on Personal Holding Companies.—For surtax on personal holding companies, see section 500.

(f) Income Not Placed on Annual Basis.—Section 47(c) shall not apply in the computation of the tax imposed by this section.

Internal Revenue Code of 1954

Subchapter G—Corporations Used to Avoid Income Tax on Shareholders

Part I—Corporations Improperly Accumulating Surplus

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

(2) a foreign personal holding company (as defined in section 552), or

(3) a corporation exempt from tax under subchapter F (section 501 and following).

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) Holding or Investment Company.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

SEC. 534. BURDEN OF PROOF.

(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) Jeopardy Assessment.—If pursuant to section 6861 (a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) Application of Section.—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

SEC. 535. ACCUMULATED TAXABLE INCOME

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to Taxable Income.—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) Charitable contributions.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) Special deductions disallowed.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) Long-term capital gains.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryover provided in section 1212).

(7) Capital loss carryover.—No allowance shall be made for the capital loss carryover provided in section 1212.

(8) Bank affiliates.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(9) Distribution of divested stock.—There shall be allowed as a deduction the amount of any dividend

distribution received of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111), was entered.

(10) Special adjustment on disposition of antitrust stock received as a dividend.—If—

(A) a corporation received antitrust stock (as defined in section 301(f) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301(f)(2) exceeded the basis of the stock determined under section 301(f)(3), and

(C) paragraph (9) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

(c) Accumulated Earnings Credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding

or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) Cross reference.—

For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551.

SEC. 536. INCOME NOT PLACED ON ANNUAL BASIS.

Section 443(b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the accumulated earnings tax imposed by section 531.

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

APPENDIX B

In the

UNITED STATES COURT OF APPEALS

For the Fifth Circuit

No. 22173

J. GORDON TURNBULL, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the Tax Court of the United States (Texas Case).

(February 1, 1967.)

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

AINSWORTH, Circuit Judge: Taxpayer petitions for review of an adverse decision of the Tax Court. The issue is whether taxpayer was availed of for the purpose of permitting earnings or profits to accumulate beyond the reasonable needs of its business (as provided by Section 102 of the Internal Revenue Code of 1939), thereby avoiding the

imposition of the surtax on its shareholders. The taxable years involved are those for the years ended November 30, 1952. November 30, 1953 and the period December 1, 1953 through February 4, 1954.

J. Gordon Turnbull, Inc., taxpayer, (JGT), was organized under the laws of Ohio in August 1941, with its principal place of business at Cleveland. It was authorized to do business in several states and furnished engineers, architectural and construction management services in connection with the building of military installations, manufacturing plants and other large structures. J. Gordon Turnbull was the controlling stockholder, president and chief executive officer until his death on April 1, 1953. JGT kept its books and records on a cash method of accounting.

In 1944, Ohio amended its corporation law to prohibit corporations from engaging in the rendering of architectural and engineering services but permitted corporations heretofore chartered for that purpose to continue in existence.

Pertinent to the issue of unreasonable accumulation of earnings and profits is an accident which occurred on November 15, 1951, on a construction job at Gregory, Texas, involving a silo in which one worker was killed and seven others injured. JGT was the architectural engineer on the job and eight damage suits in tort totaling $532,895 were filed against it as well as the joint venture general contractors, H. R. Henderson and Company and Henry C. Beck Company, and Reynolds Metals Company, the landowner. All of the injured persons were employed by a subcontractor who was building the silo when the accident occurred and which had

drawn the plans for the actual construction as well as controlled the method of construction. JGT was responsible for drawing the plans for the finished product and design of the entire plant but did not draw the plans for the silo nor did it control the subcontractors' method of installation. At the time, JGT carried general liability insurance policies with Bankers Indemnity Insurance Company and Employers Casualty Company, each for $50,000. Bankers disclaimed liability under its policy but Employers undertook the defense of the case for JGT. The tort suits were finally disposed of by settlement on November 1, 1954, by which Employers Casualty paid $5,000 on behalf of taxpayer and obtained releases in all cases. Travelers Insurance Company paid $40,000 as insurer for Henderson-Beck, and Stewart paid $4,350, a total of $49,350.

When Mr. Turnbull died, his counsel, W. A. Falsgraf, took charge of the company and instructed that all bids and quotations be recalled and no further contracts signed, as a part of a plan of liquidation agreed to with Mr. Turnbull immediately before his death. Uncompleted contracts were assigned to E. G. Novak, one of JGT's office managers. Thereafter, some employees of taxpayer sought to acquire the stock and keep the corporation's charter alive, but Falsgraf would not agree without a ruling from the Internal Revenue Service as to the tax consequences to shareholders. Falsgraf also negotiated with other interested parties with a view to a sale of the stock to a liquidation of the company.

On February 4, 1954, H. R. Henderson and Company acquired all of JGT's stock for $975,000, and JGT loaned

Henderson $801,108.37 of its cash funds to purchase the stock.

During the six fiscal years ended November 30, 1948 through November 30, 1953, JGT had substantial current income which, after deduction for current taxes and the payment of nominal dividends, left a large earned surplus balance at the end of the year. The surplus grew from $158,726.82 at fiscal 1947 to $668,412.30 at fiscal 1953.[1]

[1] The actual detail of earnings and profits less current taxes, current earnings available for dividends, dividends paid and earned surplus are shown in the following table:

Fiscal Year Ended	*Current Net Income*	*Deduct: Current Taxes*	*Current Net Income After Taxes*	*Other Adjustments to Earned Surplus*	*Current Earnings Available for Dividends*	*Dividends Paid*	*Earned Surplus Balance End of Year*
11-30-47							$158,726.82
11-30-48	$ 206,822.25	$(107,185.65)	$ 99,636.60	$4,961.98	$104,598.58	$(40,775.00)	222,550.40
11-30-49	153,646.19	(58,385.55)	95,260.64		95,260.64	(16,240.00)	301,571.04
11-30-50	300,066.40	(139,496.86)	160,569.54		160,569.54	(16,240.00)	445,900.58
11-30-51	217,629.88	(117,385.85)	100,244.03		100,244.03	—0—	546,144.61
11-30-52	31,737.67	(10,580.67)	21,157.00		21,157.00	(16,240.00)	551,061.61
11-30-53	200,090.80	(82,740.11)	117,350.69		117,350.69	—0—	668,412.30
	$1,109,993.19	$(515,774.69)	$594,218.50	$4,961.98	$599,180.48	$(89,495.00)	

The Tax Court found that the accumulation of earnings and profits was unreasonable and ordered entry of its decision against taxpayer under Rule 50 of the Rules of the Tax Court. We agree, being of the opinion that the corporation's accumulations were unreasonable and designed to avoid surtax to its shareholders.[2] The principal issue involves factual determinations and the Tax Court's findings are amply supported by the record and should be affirmed. See *Helvering v. National Grocery Co.*, 304 U.S. 282, 58 S. Ct. 932, 82 L. Ed. 1346 (1938). It is, therefore, unnecessary to decide the question of whether the Government or the taxpayer has the burden of proof.[3]

Taxpayer contends that its dividend payouts were reasonable and that the accumulation of earnings and profits in the involved years was proper to fulfill reasonable working capital needs and reserve for contingent liability on the eight tort suits. It also asserts that it was in the orderly process of liquidation and not subject to the Section 102 penalty.

Reference to Table 1 in footnote 1 shows total dividend payout by taxpayer in the six fiscal years, 1948-1953, of $89,495 out of a total of current earnings available for dividends of $599,180—hardly a substantial payment of dividends unless other factors required accumulation. Working

[2] Shareholders, Mr. and Mrs. Turnbull, were in a tax bracket of approximately 67 per cent and 66 per cent for the years 1952 and 1953.

[3] Section 534 of the 1954 Code provides that the burden of proof shall be on the Commissioner if the taxpayer complies with the conditions of the Section by filing a statement on the grounds and facts sufficient to show the basis for the accumulation. Taxpayer filed a statement but the Commissioner has contested its sufficiency, so that each side contends the other has the burden of proof.

capital needs were more than adequately taken care of when reference is made to the balance sheets of JGT. The ratio of current assets to current liabilities in 1952 was 11.12 to 1 and cash to current liabilities 5.73 to 1; and in 1953, the ratio of current assets to current liabilities was 6.97 to 1 and cash to current liabilities 6.18 to 1. It is obvious there was an ample reserve far above the cash needs of the company and that the Tax Court's holding was proper in this regard.

JGT, however, urges that the filing of the tort suits against it and other defendants in the amount of $532,895 required that in reasonable management of the business there should be a sufficiently large accumulation of earnings and profits to take care of this contingent liability. The evidence shows that taxpayer was not considered to be one of the principal defendants; that it had ample public liability insurance to cover; and that only $5,000 was paid in its behalf to settle its liability in all of the cases. We hold, therefore, that the Tax Court's findings with respect to reasonable needs for the contingent liability in these cases were correct.

Though it is true that Mr. Falsgraf curtailed the activities of taxpayer after Mr. Turnbull's death, this circumstance did not enter the case until April 1, 1953, when Mr. Turnbull died. We are considering here all of the period in fiscal 1952 and 1953 and the short year ended February 4, 1954. The corporation was not placed in liquidation and its corporate charter, because of the change of the Ohio law forbidding architects and engineers to be incorporated but reserving that right to those already chartered, was a valuable asset

to a prospective purchaser. Since the corporation was never liquidated and no distribution ever made in liquidation, in fact, the corporation's stock was sold to Henderson, the taxpayer may not properly contend that an orderly liquidation defeated the Section 102 tax. The Tax Court's ruling, therefore, is correct.

Taxpayer also urges that the Rule 50 computation is erroneous because it fails to permit deduction of current federal income taxes from current net income in computing the surtax penalty. However, the computation was made in accordance with Section 102(d)(1)(A), which permits a deduction for income taxes "paid or accrued" in the current year. The computation allows a deduction for the amount of 1952 taxes actually paid in 1953 but denies a deduction for the amount of taxes incurred but not paid in 1953. Taxpayer's books are kept on a cash rather than accrual basis. The case is squarely within the ruling of the Second Circuit in *Harry M. Stevens, Inc. v. Johnson*, 2 Cir., 1956, 238 F. 2d 436, cert. den., 353 U.S. 909, 77 S. Ct. 664, 1 L. Ed. 2d 663 (1957), where the identical question was presented and taxpayer's contention rejected.[4] The Tax Court holding is, therefore, correct.

AFFIRMED.

[4] The Government points out in its brief that such an issue would not arise under the 1954 Code because the deduction in computing Section 102 net income for taxes accrued in the taxable year is permitted whether the taxpayer is on a cash or accrual method. See Section 535(b)(1) of the Internal Revenue Code of 1954; Mertens, *Law of Federal Income Taxation*, (Rev.) Code Commentary, Section 535.2.

B-9

UNITED STATES COURT OF APPEALS

For the Fifth Circuit

October Term, 1966

No. 22173

D. C. Docket No. 88456

J. GORDON TURNBULL, INC.,

Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the Tax Court of the United States (Texas Case).

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

J U D G M E N T

This cause came on to be heard on the petition of J. Gordon Turnbull, Inc., for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

February 1, 1967

Issued as Mandate: April 7, 1967

B-10

In the

UNITED STATES COURT OF APPEALS

For the Fifth Circuit

No. 22173

J. GORDON TURNBULL, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the Tax Court of the United States (Texas Case).

(March 22, 1967)

ON PETITION FOR REHEARING

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing in the above cause be, and the same is hereby, DENIED.

B-11

41 T. C. No. 39

TAX COURT OF THE UNITED STATES

Docket No. 88456

J. GORDON TURNBULL, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

December 12, 1963.

Where petitioner accumulated earnings substantially in excess of its working capital requirements; where it was not necessary for petitioner to retain its earnings to meet any contingent liability it might have had on certain tort suits because there was virtually no possibility of liability with respect thereto; and where petitioner made large investments of funds in property unrelated to its architectural and engineering services business. *Held*, that under sec. 102, I.R.C. 1939, petitioner was availed of during the taxable years involved for the purpose of preventing imposition of surtax upon its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. *Held further*, that a fee paid to a tax firm on an obligation incurred by some of petitioner's key employees for their personal benefit was not deductible as an ordinary and necessary expense of petitioner.

W. A. Falsgraf and *S. E. Parker* for the petitioner.

Charles B. Sklar for the respondent.

W. A. Falsgraf and *S. E. Parker* for the petitioner.
Charles B. Sklar for the respondent.

DAWSON, *Judge:* Respondent determined deficiencies in petitioner's income tax as follows:

Taxable Year Ended	*Deficiency*
November 30, 1952	$29,423.11
November 30, 1953	37,355.29
February 4, 1954	93,359.35

Certain issues raised by the pleadings have been settled by the parties by stipulation which will be given effect under Rule 50. The remaining issues are: (1) whether petitioner was availed of during the taxable years before us for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed; and (2) whether a fee paid to J. K. Lasser & Company was deductible as an ordinary and necessary expense of petitioner for its taxable year ended February 4, 1954.

FINDINGS OF FACT

Some of the facts have been stipulated by the parties and are found accordingly. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

Issue 1

J. Gordon Turnbull, Inc., (hereinafter referred to as petitioner) was organized under the laws of the State of Ohio in August 1941, and maintained its principal place of business at 3626 Chester Avenue, Cleveland, Ohio. The petition-

er's principal source of income was fees received for engineering, architectural, and construction management services rendered in connection with the building of miltary bases and installations, manufacturing plants, and other large structures. J. Gordon Turnbull was the controlling stockholder, president, and chief executive officer of petitioner until his death on April 1, 1953.

Petitioner kept its books and records and prepared its income tax returns on the basis of a fiscal year ending November 30, and on a cash method of accounting. Its corporate income tax returns for the fiscal year ended November 30, 1952, and November 30, 1953, were filed with the district director of internal revenue, Cleveland, Ohio, and its separate income tax return for the taxable period December 1, 1953, through February 4, 1954, was also filed with the district director of internal revenue at Cleveland.

Exhibits A and B attached to that letter dated July 10, 1959, which is contained in Joint Exhibit 41-00, set forth the cash flow of petitioner for the fiscal years ending November 30, 1951, and November 30, 1952, and Exhibit C attached to the letter of July 10, 1959, sets forth a monthly summary of cash receipts and disbursements of petitioner for the period December 1, 1950, through November 30, 1952. The letter dated July 10, 1959, signed by a duly authorized representative of the petitioner, was submitted to Internal Revenue Service in answer to registered mail notice sent on May 11, 1959, pursuant to section 534 of the Internal Revenue Code of 1954, and sets forth the grounds upon which the petitioner relied to establish that no part of its earnings

and profits had been permitted to accumulate beyond the reasonable needs of the business.

The National City Bank of Cleveland granted a line of credit to the petitioner and its borrowings against this line of credit and the dates of repayment of the amounts borrowed are as follows:

Borrowed		*Repaid*			
Note Dated	*Amount*	*Amount Paid*	*Check No.*	*Date*	*Date of Cancellation of Note*
5-13-52	$100,000	$100,000	5990	7-11-52	7-14-52
8-4-52	100,000	100,000	6500	9-29-52	9-30-52
2-23-53	200,000	200,000	7519	3-9-53	3-9-53
3-23-53	250,000	200,000	7651	3-25-53	
		50,000	7674	3-27-53	3-27-53
4-29-53	100,000	100,000	7914	5-5-53	5-5-53
5-26-53	65,000	65,000	8104	6-8-53	6-8-53

During its fiscal year ended November 30, 1952, the number of separate jobs on which petitioner received and disbursed cash and petitioner's total cash receipts and disbursements were:

Particulars	*Number of Jobs*	*Amount FYE 11-30-52*
Total cash disbursements	48	$1,951,544.15
Total cash receipts	22	1,811,105.18
Excess of total cash disbursements over total cash receipts		$ 140,438.97

Under the terms of an agreement for the assignment of accounts receivable dated February 4, 1954, between petitioner and Price Construction Company, Price assumed any contingent liability the petitioner might have as a result of an accident which occurred on November 15, 1951, during

the construction of the Reynolds Metals Company plant at Gregory, Texas.

For the construction of its plant at Gregory, Reynolds Metals Company, the landowner, entered into six prime contracts, one with H. R. Henderson & Company and Henry C. Beck Company, who acted as general contractor as a joint venture, one with the petitioner, who was the architectural engineer, and four others. James Stewart Company was a subcontractor who built the storage silo in which the accident occurred.

On November 15, 1951, during the construction of an ore storage silo at the Reynolds plant, an accident occurred when a scaffolding or platform supported by reinforcing bars extending inside the silo collapsed. Twenty-two or 23 men who were on the scaffolding when it collapsed were injured, and of these one, Vincent Charo, was killed. The injured men were all employed by James Stewart Company or another James Stewart Corporation.

James Stewart Company had drawn the plans for the actual construction of the silo in which the accident occurred. It also had control over the method of construction to be used in building the silo. The method of using a platform supported by reinforcing bars was decided upon and executed by James Stewart Company. It was not specified by petitioner and was not a part of its design.

As architectural engineer, the petitioner was responsible for drawing the plans for the finished product, the design of the entire plant, including specifications and working draw-

ings, but they did not draw the construction plans for the actual building of the silo. Petitioner's duty of inspection on the premises was to determine that the finished product complied with their plans and specifications, as for example, ascertaining that the proper concrete mixture was being used. It was not petitioner's job to control in any way a subcontractor or his method of installation.

As a result of the accident at the Reynolds Metal plant eight tort suits were filed. Seven of these actions sought damages for personal injuries and one for alleged wrongful death (Mary Lamar Charo). In each case, by the original or amended petition, four defendants were named: H. R. Henderson & Company, Inc., Henry C. Beck Company, Reynolds Metal Company, and the petitioner. Each of these suits was filed by a person employed by James Stewart Company at the time of the injury, or by such person's representative. Hubert L. Stone, Jr., was attorney for each of the plaintiffs, and the original petitions were filed on the following dates:

Petitioner	*Docket Number*	*Date Petition Filed*
Manuel Garcia, Sr.	8238	12-31-52
Lloyd G. Bazar	8371	5-15-53
Antonio Vasquez	8186	10-25-52
Antonio Canales	8376	5-15-53
Everett O. Rippee	8430	7-3-53
Mary Lamar Charo	8174	10-11-52
L. D. Bolter	8586	11-13-53
Ramon Maldonado	8519	9-12-53

Stone, as attorney for the plaintiffs, investigated the accident, including examining the contracts, the plans for the finished project, and the plans for construction of the silo,

as well as talking to witnesses, and taking statements and depositions. Based on the information so obtained he determined what parties to name as defendants in the tort suits he filed. At the time the petitions were filed Stone believed he had the best chance for recovery against H. R. Henderson & Company, Henry C. Beck Company, and Reynolds Metals Company. At no time did he feel he had sufficient evidence to establish a prima facie case against the petitioner, but since petitioner had duties on the premises where the accident occurred, it was necessary under Texas procedure to name the petitioner as a codefendant in order to prevent the possible use of the sole proximate cause doctrine to bar any recovery.

~~In August 1963, Stone arranged to take the deposition of Femister, the project manager for Beck and Henderson. The deposition was to be taken in Dallas, Texas. Eldon Dyer, attorney for the petitioner, believed at that time that Stone could not establish a prima facie case against petitioner and felt that he could not justifiably charge it with the expense of his traveling from Corpus Christi to Dallas to attend the deposition. Stone told Dyer at that time that although he could not agree to a motion for summary judgment, he also believed he did not have a prima facie case against the petitioner.*~~

Based on his analysis of the cases, Stone disagreed with any prospect of liability on the part of the petitioner. Under the terms of the contract, the Beck-Henderson joint venture was required to indemnify Reynolds Metals Company

* This paragraph was striken by Order dated February 13, 1964 (R. 391)

against any loss from any cause of action arising from work done under the contract. In its contract with Beck-Henderson, James Stewart Company agreed to accept and assume all the liabilities, duties, and responsibilities created by the contract between Reynolds and Beck-Henderson. Since petitioner's contract was directly with Reynolds, there was no privity of contract between the injured employees of James Stewart Company and petitioner. Furthermore, Reynolds retained control over the premises and there was no significant delegation of control to petitioner. ~~Elden Dyer discussed the privity of contract with Stone about 10 days prior to the Fenister deposition which was taken in August 1953.*~~

During November 1951, the petitioner carried a comprehensive general liability policy with Bankers Indemnity Insurance Company, and a general liability policy with Employers Casualty Company. The insurance coverage under each policy was $50,000.

Employers Casualty Company was first notified of the accident by a letter dated January 13, 1953, from W. D. McArthur. Bankers Indemnity Company was similarly advised, as McArthur's letter was written to both companies. Bankers Indemnity Insurance Company disclaimed liability under its policy, but Employers Casualty Company undertook to investigate and defend the cases after receiving a non-waiver of rights agreement from the petitioner.

Falsgraf, Reidy, and Shoup, attorneys for petitioner, believed that Bankers Indemnity Insurance Company was still

* This sentence was stricken by Order dated February 13, 1964 (R. 391)

liable under the provisions of the insurance policy and had no grounds for disclaiming liability. They advised Bankers that petitioner did not waive any of its rights under its policy and would hold them responsible for all expenses and judgments obtained against it.

Employers Casualty Company completed its investigation of the accident on January 29, 1954. At that time, or shortly thereafter, based on the facts obtained from their investigation, Employers Casualty Company determined that there was no liability against petitioner on the lawsuits. Employers Casualty Company advised its reinsurer, Security Mutual Casualty Company, of the Reynolds plant accident and the facts developed by Employers' investigation thereof. With a knowledge of these facts, Security Mutual did not request Employers Casualty to take any special action with regard to the possible liability of J. Gordon Turnbull, Inc., and stated that it appeared doubtful that Turnbull was guilty of any negligence.

All of the cases filed against petitioner were disposed of by a settlement which was finally arranged in October 1954, and judgments were entered on November 1, 1954. In settlement of the suits Employers Casualty Company paid $5,000 on behalf of petitioner and obtained releases in all cases as a part thereof. Travelers Insurance Company paid $40,000 as insurer for Henry C. Beck Company and H. R. Henderson & Company, and James Stewart Company paid $4,350 in its own behalf. All the lawsuits were settled by the defendants for a total payment of $49,350. One reason the damage suits were settled for a total of $49,350 was all

of the injured men, except Vincent Charo who was killed, had recovered, had returned to work, and were earning good money by the time the cases were settled. ~~Elden Dyer, attorney for petitioner, knew of the recoveries by the injured men, some of whom returned to work within a few weeks after the accident.*~~

In its accrual basis balance sheet of November 30, 1953, the petitioner was careful to show many reserves for various expenses, including a $10,000 reserve for legal expenses on suits, but no reserve was established for any contingent liability on the lawsuits filed as a result of the Reynolds plant accident. The suits are not mentioned in a footnote to the balance sheet, although the petitions had all been filed prior to November 30, 1953.

The officers of Price Construction Company were of the opinion that the extent of contingent liability on the lawsuits would not exceed insurance coverage of $50,000, and no further indication of any contingent liability was made on the balance sheet of Price Construction Company as of February 28, 1954, which statement was examined by Q. B. Carlile, C.P.A., and as to which he rendered a qualified opinion.

At no time did either the petitioner or Price Construction Company make any payment with regard to the lawsuits resulting from the Reynolds plant accident.

W. A. Falsgraf, an attorney of Cleveland, Ohio, represented J. Gorden Turnbull from the summer of 1942 until

* This sentence was striken by Order dated February 13, 1964 (R. 391)

the death of J. Gordon Turnbull on April 1, 1953. During said period, and at all times pertinent to this case, Falsgraf also represented the petitioner. Falsgraf was elected assistant secretary of petitioner in 1945, secretary in 1947, and director in 1948. He served as secretary and director from 1948 through the taxable periods involved herein. Prior to the death of J. Gordon Turnbull, Falsgraf and Turnbull had decided that immediately upon Turnbull's death the petitioner should be put into immediate dissolution and should not be permitted to continue the active conduct of any business. Immediately after Turnbull's death, Falsgraf went to Turnbull's residence in Los Angeles and met with the vice president and treasurer of petitioner. He called the home office of petitioner in Cleveland and instructed that all bids and quotations were to be recalled and no further contracts were to be signed. This course of action was followed by Falsgraf because of the decision reached by him and Turnbull prior to Turnbull's death. As a part of the plan for the liquidation of petitioner, uncompleted contracts for job agreements at its Kansas City office were assigned to E. G. Novak, the manager of such office for completion.

In 1944, the General Corporation Law of the State of Ohio was amended to prohibit corporations from engaging in the business of rendering architectural and/or engineering services. The amending act, however, permitted corporations having charters granted prior to its effective date containing power to engage in such activities to continue to do so. Under the so-called "grandfather" clause, the corporate charter of petitioner was not affected by the amend-

ment of 1944, and it could continue to act in its corporate capacity as a consulting and superintending engineer and architect.

At all times pertinent hereto the petitioner was licensed and qualified to do business as a foreign corporation in the following States Arizona, Arkansas, California, Illinois, Indiana, Michigan, Missouri, Ohio, Wisconsin, New York, Texas, and Washington.

In late April or early May 1953 certain employees of petitioner sought to acquire the corporate stock and keep the corporate charter alive. A plan was developed whereby these employees could purchase the petitioner's treasury shares for $50,000. An advance ruling on this plan was requested from the Internal Revenue Service to determine whether proposed distributions to the Estate of J. Gordon Turnbull and to Susan A. Turnbull would constitute distributions in partial liquidation under section 115(c) of the Internal Revenue Code of 1939, and that no part of such distributions would be taxable as an ordinary dividend income. The advance ruling was requested on behalf of the Estate of J. Gorden Turnbull and Susan A. Turnbull for the reason that the case of *Zenz v. Quinlivan*, 106 F. Supp. 57, had been decided by the U. S. District Court for the Northern District of Ohio, Western Division, on June 27, 1952. Falsgraf advised Susan Turnbull and told the employees who sought to purchase the company's stock so as to keep the corporate entity in existence that he would not approve such sale in the absence of an advisory ruling from Internal Revenue Service

that the *Zenz* case would not be applicable to the transaction, but that it would qualify as a partial liquidation.

As counsel for Susan Turnbull and the Estate of J. Gordon Turnbull, Falsgraf would have preferred a sale of the stock of the corporation to a liquidation because of the pending litigation.

In addition to negotiating for the sale of the petitioner's stock to its employees, Falsgraf negotiated with other interested parties with a view to a sale of petitioner's stock. These included Reynolds Metals Company, Peter Kiewit, Allen & Company, and the Guy B. Pinero organization. These potential purchasers would not go forward with an acquisition of petitioner's stock and one of the reasons given was the existence of the pending lawsuits resulting from the Reynolds plant disaster.

During its 6 fiscal years ended November 30, 1948, through November 30, 1953, the petitioner's income tax returns, with minor adjustments, had net income after taxes, current earnings available for dividends, dividends paid, and earned surplus balances, as reflected in Table 1.

During these fiscal years the changes in petitioner's assets and liabilities, its financial position, and its ratios of current assets to current liabilities and cash to current liabilities were as shown in Table 2.

Table 1

Fiscal Year Ended	*Current Net Income*	*Deduct: Current Taxes*	*Current Net Income After Taxes*	*Other Adjustments to Earned Surplus*	*Current Earnings Available for Dividends*	*Dividends Paid*	*Earned Surplus Balance End of Year*
11-30-47							$158,726.82
11-30-48	$ 206,822.25	$(107,185.65)	$ 99,636.60	$4,961.98	$104,598.58	$(40,775.00)	222,550.40
11-30-49	153,646.19	(58,385.55)	95,260.64		95,260.64	(16,240.00)	301,571.04
11-30-50	300,066.40	(139,496.86)	160,569.54		160,569.54	(16,240.00)	445,900.58
11-30-51	217,629.88	(117,385.85)	100,244.03		100,244.03	—0—	546,144.61
11-30-52	31,737.67	(10,580.67)	21,157.00		21,157.00	(16,240.00)	551,061.61
11-30-53	200,090.80	(82,740.11)	117,350.69		117,350.69	—0—	668,412.30
	$1,109,993.19	$(515,774.69)	$594,218.50	$4,961.98	$599,180.48	$(89,495.00)	

Table 2

Particulars	Fiscal Year Ended 11-30-47	11-30-48	11-30-49	11-30-50	11-30-51	11-30-52	11-30-53
Assets							
Current Assets:							
Cash	$182,282.56	$214,261.70	$153,041.11	$399,976.64	$290,997.09	$205,505.89	$563,463.77
Notes & Accounts Receivable:							
Computer Research Corp.					103,945.68	194,775.36	
Other	31,012.88	30,462.91	36,412.69	13,177.39	97,175.20	(2,005.36)	71,351.01
Total Current Assets	$213,295.44	$244,724.61	$189,453.80	$413,154.03	$492,117.97	$398,275.89	$634,814.78
Investments:							
Big Island Inc. Stock						33,700.00	
Computer Research Corp. stock						5,070.00	
Treasury stock	59,350.00	59,350.00	62,875.20	62,875.20	62,875.20	62,875.20	62,875.20
Partnership investment		29,721.39	80,481.51	26,561.98			
Fixed & Other Assets:							
Automobiles	12,349.92	17,732.19	25,811.35	36,771.27	35,533.99	38,837.42	14,637.13
Furniture & Fixtures	45,964.35	56,749.61	59,975.87	77,415.36	101,002.14	105,185.95	58,836.48
Building	66,473.63	70,455.00	135,455.00	158,133.56	127,257.97	128,550.05	119,152.77
Less: Reserve for depreciation	(26,990.78)	(36,798.76)	(45,600.53)	(61,275.64)	(74,680.98)	(87,370.29)	(62,027.74)
Land	75,416.87	75,533.42	85,533.42	82,283.42	215,158.42	155,062.37	130,263.00
Deposits	950.00	1,021.85	1,049.65	3,109.30	610.85	672.85	989.07
Leasehold Improvements					232.83	7,128.15	
Total Assets	$446,809.43	$518,489.31	$595,035.27	$799,028.48	$960,108.39	$847,987.59	$959,540.65

Table 2 (Continued)

Particulars	*Fiscal Year Ended* 11-30-47	11-30-48	11-30-49	11-30-50	11-30-51	11-30-52	11-30-53
Liabilities & Capital							
Current Liabilities:							
Accounts Payable							
Deposits Payable	$ 50.00						
Accrued income taxes	$ 66,302.13	$ 78,592.46	$ 58,385.55	$139,496.86	$119,382.94	$ 10,580.67	$ 82,740.11
Employees tax	21,780.48	17,346.45	10,921.13	13,631.04	19,955.84	25,222.67	8,388.24
Total Current Liabilities	$ 88,082.61	$ 95,938.91	$ 69,306.68	$153,127.90	$139,338.78	$ 35,803.34	$ 91,128.35
Bonds, Notes & Motgage Payable			24,157.55		74,625.00	61,122.64	
Total Liabilities	$ 88,082.61	$ 95,938.91	$ 93,464.23	$153,127.90	$213,963.78	$ 96,925.98	$ 91,128.35
Capital Stock	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00
Earned Surplus & Undivided Profits	158,726.82	222,550.40	301,571.04	445,900.58	546,144.61	551,061.61	668,412.30
Total Liabilities & Capital	$446,809.43	$518,489.31	$595,035.27	$799,028.48	$960,108.39	$847,987.59	$959,540.65
Ratio of: Current Assets to Current Liabilities	2.42:1	2.55:1	2.73:1	2.70:1	3.53:1	11.2:1	6.97:1
Cash to Current Liabilities	2.07:1	2.23:1	2.21:1	2.61:1	2.09:1	5.73:1	6.18:1

Petitioner's financial position and the ratios of its current assets to current liabilities, cash to current liabilities, and current assets to total liabilities as of November 30, 1953, on an accrual basis, were as follows:

Assets

Cash	$521,713.77
Other current assets	669,008.14
Total current asssets	$1,190,721.91
Fixed Assets	260,861.60
Total assets	$1,451,583.51

Liabilities and Capital

Liabilities:

Current liabilities	$ 11,888.24
Reserves	433,251.77
Total liabilities	$ 445,140.01

Capital:

Capital stock	$ 137,124.80
Retained earnings	869,318.70
Total liabilities and capital	$1,451,583.51

Ratio of:

Current assets to current liabilities —	110.16:1
Current assets to total liabilities —	2.67:1
Cash to current liabilities —	43.88:1
Cash to total liabilities —	1.17:1

During petitioner's fiscal year ended November 30, 1952, J. Gordon Turnbull received a salary of $60,000 from petitioner but no salary was paid to Susan A. Turnbull. For its fiscal year ended November 30, 1953, petitioner paid J. Gordon Turnbull a salary of $35,000 and Susan A. Turnbull a

salary of $12,500. These salaries are included in the deduction for compensation of officers claimed on petitioner's income tax return for each year.

At its meeting on January 18, 1954, the board of directors of H. R. Henderson & Company, in considering the possibility of purchasing the stock of petitioner, knew and took recognition of the fact that, in the event of such a purchase, it would be possible for Henderson to obtain a large part of the purchase price from petitioner.

On February 4, 1954, petitioner's board of directors recognized its cash position was such that it could loan $800,000 to H. R. Henderson & Company. This loan was utilized by Henderson in its purchase of petitioner's stock. Petitioner actually loaned H. R. Henderson & Company $801,108.37 in order that Henderson might purchase petitioner's outstanding stock. Funds for the purchase of the outstanding shares of petitioner were provided

By H. R. Henderson & Company:	
Borrowed from Cameron McElroy and H. R. Henderson	$ 25,000.00
Borrowed from J. Gordon Turnbull, Inc.	801,108.37
Total	826,108.37
By J. Gordon Turnbull, Inc., (treasury shares):	148,891.63
Total	$975,000.00

On or about February 4, 1954, H. R. Henderson & Company acquired all of the outstanding shares of petitioner for a total price of $975,000, paid as follows:

	Number of Shares	Amount
Paid by H. R. Henderson Co. to:		
Susan A Turnbull	330	$198,121.92
J. Gordon Turnbull Estate	1,046	627,986.45
Total amount paid by H. R. Henderson Co.		$826,108.37
Paid by J. Gordon Turnbull, Inc. to:		
Estate of J. Gordon Turnbull	248	148,891.63
Totals	1,624	$975,000.00

As specified in the offer to purchase dated January 25, 1954, Susan A. Turnbull purchased from petitioner for cash the following assets at their book value as of December 31, 1954:

½ Ton Chevrolet truck	$ 1,036.08
1952 Cadillac	3,537.03
Moraga Drive property	56,111.15
San Fernando ranch	118,280.50
Chester Avenue property	49,068.17
Ranch machinery and equipment	12,087.47
Total	$240,120.40

During the years 1951, 1952, and 1953, all of petitioner's issued and outstanding capital stock was owned by J. Gordon Turnbull, Susan A. Turnbull, and the Estate of J. Gordon Turnbull.

In its income tax return for the year December 1, 1953, through November 30, 1954, the petitioner reported a gain on sale of its accounts receivable in the amount of $158,726.20. In computing the tax due on this return, the petitioner prorated this gain, along with all its taxable income, between its separate return for the taxable period December 1, 1953, through February 4, 1954 (66 days), and the

period February 5 through November 30, 1954 (299 days). For the latter period, the income of petitioner, so prorated, was included in the consolidated return filed with and in the name of its parent company, H. R. Henderson & Company.

In the notice of deficiency pertaining to the short taxable year of petitioner, ended February 4, 1954 (Docket No. 88456), respondent determined that the $158,726.20, which petitioner reported as gain on sale of accounts receivable, should be completely reallocated to said short taxable year.

In the notice of deficiency pertaining to the consolidated return of H. R. Henderson & Company and the petitioner, for the taxable year 1954 (Docket No. 1285-62), respondent determined that the income reported on said consolidated return should be increased by the amounts collected on the accounts receivable of petitioner during the period from February 4, 1954, through December 31, 1954, which collections amounted to $423,777.25. Respondent further determined that this sum could properly be reduced by a basis in said accounts of $41,273.80, collection expenses of $13,550.48, and the gain from sale of receivables reported by petitioner on its return for the period December 1, 1953, through November 30, 1954, in the amount of $158,726.20, leaving the determined increase in reported consolidated income for 1954 from this adjustment of $210,226.77.

As a result of the issuance of the notices of deficiencies dated May 13, 1960 (Docket No. 88456), and January 22, 1962 (Docket No. 1285-62), the sum of $158,726.20 was twice included in income since the sale of the accounts receivable

was recognized by the respondent in his notice dated May 13, 1960 (Docket No. 88456), for the taxable year ended February 4, 1954, and the sale was not recognized by the respondent in his notice dated January 22, 1962 (Docket No. 1285-62), for the year ended December 31, 1954, but was considered to have been income which was not reported on the consolidated return of H. R. Henderson & Company and petitioner for the year 1954.

On May 13, 1960, respondent issued his notice of deficiency in which he determined that with respect to the taxable years ended November 30, 1952, November 30, 1953, and the taxable year December 1, 1953, through February 4, 1954, the petitioner was formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders by permitting earnings or profits to accumulate instead of being distributed, and that petitioner was subject to the provisions of section 102, Internal Revenue Code of 1939.

Issue 2

In connection with their negotiations to purchase the stock of petitioner and the ruling requested with regard thereto, certain of petitioner's employees retained the firm of J. K. Lasser & Company. This firm was not employed by petitioner, but was retained by key employees in their own behalf. After H. R. Henderson & Company acquired the stock of petitioner, J. K. Lasser & Company sent a bill for $3,500 to W. D. McArthur who represented the employees. At first W. A. Falsgraf, acting for petitioner, refused to pay

this bill on the ground that it was an obligation of the employees, but Cameron McElroy authorized the payment by petitioner since he was fearful that certain key employees might resign if the petitioner did not pay the bill.

In his notice of deficiency dated May 13, 1960, the respondent disallowed the fee paid to J. K. Lasser & Company as a deduction because it was not regarded as an ordinary and necessary expense of petitioner.

ULTIMATE FINDINGS

1. During each of its taxable years ended November 30, 1952, November 30, 1953, and February 4, 1954, petitioner permitted its earnings to accumulate beyond the reasonable needs of its business.

2. For each of its taxable years ended November 30, 1952, November 30, 1953, and February 4, 1954, petitioner was availed of for the purpose of preventing the imposition of surtax on its shareholders through the medium of permitting its earnings to accumulate instead of being divided or distributed.

3. The $3,500 fee paid by petitioner to J. K. Lasser & Company for some of its key employees was not an ordinary and necessary expense of petitioner.

OPINION

Issue 1

Section 102(a) of the Internal Revenue Code of 1939 provides that if a corporation is availed of for the purpose of preventing the imposition of surtax on its shareholders by

permitting earnings or profits to accumulate instead of being distributed, then the corporation is subject to a surtax on the amount of undistributed section 102 net income. Section 102(c) provides that the accumulation of earnings or profits beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation proves to the contrary by the clear preponderance of evidence.

Under section 534, Internal Revenue Code of 1954, which is applicable to this case, if respondent sends the taxpayer a notification of the proposed determination regarding accumulated earnings tax, and in response thereto the taxpayer submits an *adequate* statement of grounds on which the taxpayer relies, along with supporting facts, then respondent must bear the burden of proving, with respect to the relevant grounds set forth in said statement, that the taxpayer permitted its earnings or profits to accumulate beyond the reasonable needs of its business. To be *adequate* to shift to respondent the burden of proof with respect to the grounds set forth in the taxpayer's statement, the supporting facts submitted by the taxpayer must be substantial, material, definite, and clear. *American Metal Products Corporation*, 34 T.C. 89 (1960), affirmed 287 F. 2d 860 (C.A. 8, 1961).

In this case the respondent did, as we have heretofore found, send a notification to the petitioner in accordance with the provisions of section 534; and the petitioner submitted a timely statement in which it purported to set forth certain grounds and supporting facts on which it relies to establish that its earnings and profits had not been permit-

ted to accumulate beyond the reasonable needs of its business during the years in controversy.

But respondent contends that the facts contained in the petitioner's statement dated July 10, 1959, do not meet the requirements of the statute and the regulations and are insufficient to shift the burden of proof to respondent. His contention is based on the following points:

1. All the information submitted by the petitioner regarding cash receipts and disbursements pertain to the fiscal years ended November 30, 1951, and November 30, 1952. It did not submit any such information for its fiscal years ended November 30, 1953, and February 4, 1954, although these years were included in the notice mailed to petitioner on May 11, 1959. That the information submitted was carefully considered by respondent is shown by the fact that the fiscal year ended November 30, 1951, was not included in the notice of deficiency, but petitioner did not submit any information on its cash flow or cash position for 2 of the 3 years now before us.

2. The few allegations contained in the statement regarding the Reynolds plant accident were so vague and indefinite that respondent was not informed as to the basis or reasons for the petitioner's position. Specific facts should be set forth in petitioner's statement, not mere allegations of its contention. See *Wellman Operating Corporation*, 33 T.C. 162, 184 (1959); and *American Metal Products Corporation*, *supra*. Petitioner's statement contains the following incorrect information: (a) the accident occurred on November

15, 1951, not during petitioner's fiscal year 1953, as stated; (b) the storage silo was not constructed by petitioner; (c) the entire silo did not collapse; (d) "many" construction workers were not killed; (e) only one action for wrongful death was filed, not "numerous wrongful death lawsuits"; (f) the one suit for wrongful death filed named three other parties as codefendants along with petitioner. The facts omitted from petitioner's statement regarding the accident left respondent completely uninformed concerning it. Petitioner did not name any of the parties involved, where, when, or how the accident occurred, what suits had been filed and where, who were petitioner's insurers, the amount of coverage, or that one such company undertook to investigate the accident. Petitioner did not specify what prospective purchasers were contacted and any facts as to what happened during any negotiations which might have occurred.

3. Petitioner's stated ground that cash was required for completion of contracts on hand was merely an allegation. No facts were submitted in support thereof. Petitioner offered no explanation of why a business, which was inactive and accepting no new work after April 3, 1953, needed such large amounts of working capital. Petitioner also did not state that on or about July 1, 1953, some of its contracts had been assigned to E. G. Novak for completion.

In view of the foregoing we have concluded that the petitioner's statement was not sufficiently clear and definite to affect a shift in the burden of proof in relation to accumulations beyond the reasonable needs of the business.

See *I. A. Dress Co., Inc.*, 32 T.C. 93 (1959), affd. 273 F. 2d 543 (C.A. 2, 1960), certiorari denied 362 U.S. 976. However, irrespective of the burden of proof issue, we think the record in this case persuasively demonstrates that petitioner's financial position at the begining of and during the years in question was adequate to meet its business needs, both immediate and anticipated, that additional accumulations were unreasonable, and that the corporation was availed of for the purpose of preventing the imposition of surtax upon its principal shareholders. Cf. *Barrow Manufacturing Company, Inc., v. Commissioner*, 294 F. 2d 79 (C.A. 5, 1961), affirming a Memorandum Opinion of this Court.

We turn now to a consideration of the grounds asserted by the petitioner and of the evidence pertinent thereto, bearing in mind that whether a corporation was availed of for the purpose of avoiding the income tax with respect to its shareholders and whether earnings and profits were permitted to accumulate beyond the reasonable needs of the business are both questions of fact. *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938) and *James M. Pierce Corporation*, 38 T.C. 643, 652 (1962).

Petitioner argues that it retained certain of its earnings to meet its reasonable business needs for the following reasons:

> (a) The nature of petitioner's engineering, consulting, and contracting services required extensive working capital to cover expenditures against work in progress which generally exceeded collections on fees during the greatest portion of the time the job was on the company's books. Such expenditures were required to be

made during the progress of the work, but fee collections were almost always deferred to the close of the job, and in many instances retentions of up to 10 percent of the contract price could be held for extended periods.

(b) Petitioner's cash position during the years here involved was so precarious as to require the establishment of a line of credit for borrowings to meet payrolls and its needs for short term working capital.

(c) The disaster at Gregory, Texas, on November 15, 1951, confronted petitioner with claims for damages exceeding $500,000, against which it had insurance in force of not to exceed $100,000, the carriers of which had disclaimed liability.

Petitioner further argues that there was a complete absence of intent on its part to avoid the imposition of surtax on its shareholders and that such intent is evidenced by these circumstances:

(a) During the period from 1947 until the death of J. Gordon Turnbull the petitioner had paid substantial cash dividends whenever its cash position was such that they were warranted.

(b) After the date of death of J. Gordon Turnbull, the petitioner was in a de facto status of liquidation and distribution of its assets could have been accomplished at any time with favorable capital gain treatment to its shareholders.

(c) The plan proposed by certain of its employees involving a stock purchase followed by a redemption of the remaining shares held by the Estate of J. Gordon Turnbull and his widow was deemed by Internal Revenue Service in its ruling letter to be a partial liquidation within the meaning of section 115(c) of the Internal Revenue Code of 1939.

(d) Petitioner was not liquidated because of the value of the corporate entity with its charter permitting the

rendering of engineering services and because of the potential transferee liability to the Estate of J. Gordon Turnbull and his widow from the Texas litigation.

Working capital requirements and cash position.—The record reveals that for its 6 fiscal years ended November 30, 1947, through November 30, 1953, the petitioner had total current earnings available for dividends of $599,180.48 from which it paid dividends of $89,495, or a total of 14.94 percent. It is apparent, as shown in our Findings of Fact, that the largest part of these dividends was paid before 1951. But even more significant is that for the latter 3 fiscal years, the petitioner had current earnings available for dividends of $238,751.72, and paid only one dividend in 1952 of $16,240, or only 6.80 percent. While in its fiscal year ended November 30, 1952, the first year at issue here, the petitioner paid out a large part of its earnings in dividends, for its next year ended November 30, 1953, it had much larger current earnings available ($117,350.69), but paid no dividends at all. Thus, during the years November 30, 1952, and November 30, 1953, the petitioner's retained earnings, even after the 1952 dividend, increased $4,917 and $117,350.69, respectively, or a total of $122,267.69.

Petitioner's cash basis balance sheets for these 2 years indicate that as retained earnings increased in such substantial amounts, the corporation's financial condition was both sound and liquid, and that its cash position was particularly strong. At the end of each of these 2 years, petitioner had no current liabilities other than accrued taxes; its current assets exceeded its total liabilities in each year by $301,349.91 and $543,686.43, respectively; and it had cash in excess of

total liabilities in each year of $108,579.91 and $472,335.42, respectively. Its current ratio was 11.12 to 1 at November 30, 1952, and 6.97 to 1 at November 30, 1953. Moreover, the ratio of cash to current liabilities was 5.73 to 1 and 6.18 to 1 in these years. Petitioner's cash position was so strong that it could have easily paid all its liabilities and had excess cash of over $108,000 as of November 30, 1952, and over $472,000 as of November 30, 1953. In light of these facts, we are not persuaded that petitioner had any kind of cash problems, let alone that its cash position was precarious. Its working capital appears to have been entirely adequate for its needs.

That petitioner engaged in some short term borrowing does not detract from the fact that its working capital was more than adequate. Only two loans were made in fiscal year 1952 for about 60 days each. The four loans made in fiscal year 1953 were all in the first part of the year and were for terms of 14, 4, 6, and 13 days, respectively. The fact that petitioner could obtain such loans and repay them in only a few days indicates the strength rather than the weakness of its finances. See *Kerr-Cochran, Inc., v. Commissioner*, 253 F. 2d 121 (C.A. 8, 1958), affirming a Memorandum Opinion of this Court, involving quick bank loan repayments.

On an accrual basis petitioner's financial condition at November 30, 1953, was even better than on a cash basis. The ratio of current assets to current liabilities was 100.16 to 1; the ratio of current assets to total liabilities was 2.67 to 1;

the ratio of cash to current liabilities was 43.88 to 1; and the ratio of cash to total liabilities was 1.17 to 1.

By February 4, 1954, petitioner's liquidity and cash position was enhanced by Susan A. Turnbull's purchase, for cash, of various fixed assets owned by the petitioner at their book value as of December 31, 1953, in the total amount of $240,120.40.

At its meeting on January 18, 1954, the board of directors of H. R. Henderson & Company, in considering the possibility of purchasing the stock of petitioner, knew and took special recognition of the fact that in the event of such a purchase, it would be possible for Henderson to obtain a large part of the purchase price from petitioner. Similarly, on February 4, 1954, petitioner's board of directors recognized its cash position was such that it could loan $800,000 to H. R. Henderson & Company. This loan was utilized by Henderson in its purchase of petitioner's stock. As part of the purchase of its stock, petitioner actually loaned H. R. Henderson & Company $801,108.37, and in addition paid $148,891.63 to the Estate of J. Gordon Turnbull, in order to acquire 248 shares of its own stock to be held as treasury shares. Thus, petitioner's accumulated earnings were utilized to finance the sale of petitioner's outstanding stock from Susan A. Turnbull and the Estate of J. Gordon Turnbull, petitioner's only stockholders, to H. R. Henderson & Company. We think this use of accumulated corporate earnings was essentially for the personal benefit of petitioner's stockholders and was the final step in the plan to avoid the imposition on these stockholders of surtax on

accumulated corporate earnings. In our opinion such a use indicates that the earnings and profits of the corporation have been accumulated beyond the reasonable needs of the business. See *Pelton Steel Casting Co. v. Commissioner*, 251 F. 2d 278 (C.A. 7, 1958), certiorari denied 356 U.S. 958.

Still another reason why petitioner's working capital was not inadequate during its taxable years ended November 30, 1953, and February 4, 1954, is that after the death of J. Gordon Turnbull on April 1, 1953, petitioner's operations were greatly curtailed. Petitioner accepted no new work from April 1, 1953, through February 4, 1954. Additionally, on or about July 1, 1953, the petitioner assigned the uncompleted contracts in its Kansas City office to E. G. Novak, the manager of its Kansas City office, for completion. Petitioner therefore did not have any financial burden in connection with the completion of these jobs during the latter part of its fiscal year 1953.

During 1953 the petitioner was in the process of winding up its affairs, although no formal plan of liquidation had been adopted. The mere fact that a corporation is in the process of liquidation or winding up its affairs does not prevent the application of the tax on unreasonable accumulations of earnings. To the contrary, if a taxpayer's business has terminated or become inactive, usually there is no longer any reasonable business need for retaining accumulated earnings. In *Egan, Inc. v. Commissioner*, 236 F. 2d 343 (C.A. 8, 1956), affirming a Memorandum Opinion of this Court, the accumulated earnings tax was imposed where the corporation had ceased doing business upon the termination of

its franchise during the taxable year. See also *Eastern Railway and Lumber Co.*, 12 T.C. 869 (1949).

Possible liability on tort suits.—Although petitioner earnestly contends that it was compelled to maintain large cash reserves to meet any contingent liability it might have had on the tort suits arising out of the accident at the Reynolds plant, we are satisfied that the evidence establishes that petitioner's belief was groundless and unfounded. We do not regard this as a realistically foreseeable contingency in view of all the facts and circumstances involved. The cases relied on by the petitioner, namely, *Casey v. Commissioner*, 267 F. 2d 26 (C.A. 2, 1959) and *William C. Atwater & Co., Inc.*, 10 T.C. 218 (1948), involved facts which differ substantially from those present in the instant case and, consequently, are distinguishable. In *Casey*, a suit filed by the estate of Brian T. Moran, a former employee of Bankers Development Corporation, to recover claimed commissions was on appeal to the Court of Appeals of the State of New York; and in the *Atwater* case, where a large judgment would have to have been paid if an appeal were unsuccessful, an attachment of bank accounts already had been made, thus indicating the reality of the need. We are more inclined here to give considerable weight to evidence bearing on the likelihood of the occurrence of the contingency, even though we are cognizant of the normal uncertainties of litigation. Cf. *Oyster Shell Products Corporation v. Commissioner*, 313 F. 2d 449 (C.A. 2, 1963), affirming a Memorandum Opinion of this Court; *Gibbs & Cox v. Commissioner*, 147 F. 2d 60 (C.A. 2, 1945); and *Trico Products Corporation v. McGowan*, 169 F. 2d 343 (C.A. 2, 1948).

This record shows that the petitioner was in no way responsible for the accident, which had occurred when a scaffolding or platform supported by reinforcing bars extending inside an ore storage silo collapsed injuring about 22 employees of James Stewart Company. James Stewart Company, which had drawn the plans for the actual construction of the silo, had complete control over the method of construction utilizing the platform supported by reinforcing bars. This method was not specified by petitioner and was not part of its design. As architectural engineer, petitioner's responsibility was limited to drawing plans for the finished product, the design of the entire plant, and its duty of inspection was merely to determine that the finished product complied with their plans and specifications. Petitioner had no control over any subcontractor or his method of installation. The circumstances under which the accident occurred made any liability by petitioner highly improbable.

From his study of the case and investigation of the accident, Hubert L. Stone, attorney for each of the plaintiffs in the tort suits, believed when he filed the suits that he had the best chance of recovery against the parties defendant other than the petitioner and at no time did he feel he had sufficient evidence even to establish a prima facie case against petitioner. It was only because of a rule of Texas procedure that he even named petitioner as a codefendant.

~~As early as August 1953, Eldon Dyer, petitioner's attorney, recognized that there was no prima facie case against it and was so certain of his position that he felt he could not justifiably charge his client with the expense of his traveling from~~

~~Corpus Christi to Dallas to attend the deposition of an important witness. At that time Stone told Dyer that he (Stone) also recognized he did not have a prima facie case against petitioner. Thus, it would seem that the officers and directors of petitioner knew at that time there was almost no chance of any liability on the Reynolds plant tort suits.*~~

The record also shows that at no time were the officers and directors too concerned about any liability as a result of the Reynolds plant accident. Their lack of concern is evidenced by the fact that although the accident occurred on November 15, 1951, they did not notify either of their two insurers of the accident until January 13, 1953.

One of petitioner's insurers disclaimed liability under its policy and the other (Employers Casualty Company) undertook to investigate and defend the case after receiving a non-waiver of rights agreement. Petitioner's attorneys, Falsgraf, Reidy and Shoup, believed the disclaiming company was still liable under the provisions of the insurance policy and had no grounds for disclaiming liability.

After its investigation was completed about January 29, 1954, Employers Casualty Company concluded there was no liability against petitioner on the lawsuits. In spite of the size of the alleged damages, Security Mutual Casualty Company, reinsurer for Employers Casualty Company, with knowledge of the facts, did not request Employers to take any special action because it appeared doubtful to them that petitioner was guilty of any negligence.

* This paragraph was stricken by Order dated February 13, 1964 (R 391).

Although actual settlements of the suits were negotiated over a period of months, all were settled by October 1954, and judgments were entered on November 1, 1954. In settlement of the suits, Employers Casualty Company paid only $5,000 on behalf of petitioner and obtained releases in all the cases. A total of $44,350 was paid by or on behalf of the other defendants, and all the lawsuits were therefore settled by all the defendants for a total payment of $49,350. Neither the petitioner nor Price Construction Company ever made any payment as a result of the Reynolds plant lawsuits.

Furthermore, in its accrual basis balance sheet of November 30, 1953, the petitioner showed many reserves for various expenses, including $10,000 reserve for legal expenses on suits, but no reserve was established for any contingent liability on the lawsuits filed as a result of the Reynolds plant accident.

The foregoing facts convince us that petitioner at no time had any appreciable contingent liability on the tort suits, and that petitioner's officers and directors were well informed as to all the facts regarding the accident as well as the extremely small chance of petitioner's having any liability with regard thereto. Reasonable business needs do not include the retention of earnings and profits to provide against such unrealistic contingencies. Moreover, whatever possibility of loss might have existed was more than adequately provided for by the earnings which petitioner had accumulated by November 30, 1951, prior to the years before us, which amounted to $546,144.61. It is recognized that

prior years' retained earnings should be taken into consideration in determining whether the retention and accumulation of current year's earnings is required by the reasonable needs of the taxpayer's business. *Casey v. Commissioner, supra.*

Other factors.—While petitioner's business was to provide architectural and engineering services, it invested large sums in real estate unrelated to its business. The most significant of these unrelated investments was a ranch, or farm, in San Fernando, California, in which petitioner invested $119,625, and which was sold to Susan A. Turnbull for cash at its book value as of December 31, 1954. This property was operated as a farm and crops were grown on it for a few years. This large investment of funds in property unrelated to petitioner's business indicated that petitioner was accumulating its earnings beyond the reasonable needs of its business. See *J. M. Perry & Co. v. Commissioner*, 120 F. 2d 123 (C.A. 9, 1941); and *Raymond I. Smith, Inc.*, 33 T.C. 141 (1959), affd. 292 F. 2d 470 (C.A. 9, 1961). This is another crystallizing agent for persuasion as to the lack of reasonable business needs.

During petitioner's fiscal year ended November 30, 1952, J. Gordon Turnbull received a salary of $60,000. For the fiscal year ended November 30, 1953, petitioner paid J. Gordon Turnbull a salary of $35,000 and Susan A. Turnbull a salary of $12,500. These salaries, which were included in the deduction for compensation of officers claimed on petitioner's income tax return for each year, show that J. Gordon Turnbull and his wife, who were the sole stockholders of peti-

tioner, were in a tax bracket of approximately 67 percent and 66 percent for the years 1952 and 1953. Consequently, the retention of earnings by the corporation represented a substantial tax savings to petitioner's stockholders. See *McCutchin Drilling Co. v. Commissioner*, 143 F. 2d 480 (C.A. 5, 1944).

Looking as we do at the totality of the evidence, we hold for the respondent on this issue.

Issue 2

With respect to the question involving the deductibility of the professional fee paid to J. K. Lasser & Company, the petitioner asserts that the payment was made under such circumstances and at such time as to encourage some of its key employees to remain in their same positions with its new owners. Therefore, the petitioner contends that the payment is analogous to the creation of a profit sharing trust for the benefit of corporate employees or other employee benefits designed to encourage loyalty and continuity of service and, as such, it constitutes an ordinary and necessary expense of this petitioner. Respondent, on the other hand, contends that this paid fee is not an ordinary and necessary expense of petitioner because (1) the services for which the charge was made had been rendered to the petitioner's employees and for their benefit rather than to the corporation or for its benefit, and (2) the bill was not paid until after February 4, 1954, and thus was not deductible by petitioner, a cash basis corporation, in its taxable year ended February 4, 1954.

We agree with the respondent. According to the testimony of petitioner's witness, W. A. Falsgraf, J. K. Lasser & Company was retained by the employees and rendered services to them for their benefit, not to petitioner corporation or for its benefit. Falsgraf himself at first refused to let petitioner pay this bill because it was an obligation incurred by the employees. Legal fees paid on behalf of, and for services rendered to, another are generally not deductible as ordinary and necessary expenses of the payer. See *Royal Cotton Mill Co.*, 29 T.C. 761 (1958); and compare *Schalk Chemical Co.*, 32 T.C. 879, 889 (1959), affd. 304 F. 2d 48 (C.A. 9, 1962); *Standard Linen Service, Inc.*, 33 T.C. 1, 17 (1959); and *Baxter D. Whitney & Son, Inc.*, 20 B.T.A. 380 (1930). Our review of prior decisions relating to this particular area of the law convinces us that this expense should not be allowed to petitioner. To be sure, this situation is unlike *Champion Spark Plug Co.*, 30 T.C. 295 (1958), where the taxpayer's payment of $33,750 to an employee disabled because of illness was held to be an ordinary and necessary business expense; or *Cecil R. Hopkins*, 30 T.C. 1015 (1958), where deposits made by the taxpayer at Christmas in savings accounts for children of its employees were treated as proximately related to the taxpayer's business and therefore deductible as ordinary and necessary expenses. The mere fact that the employees might have resigned if the corporation had not paid their obligation is not, in our opinion, sufficient to qualify the payment as an ordinary and necessary expense of petitioner. A taxpayer may not assume the deductions of another by the simple expedient of payment.

Falsgraf also testified that J. K. Lasser & Company sent the bill in question to W. D. McArthur, the employee's representative, after H. R. Henderson & Company had acquired petitioner's stock, and that Cameron McElroy, who was just getting started in the operation of petitioner, authorized the payment. Since H. R. Henderson & Company did not acquire the stock of petitioner until February 4, 1954, and since the bill was not received and payment was not made until after that date, petitioner, being on a cash basis, could not, in any event, properly claim a deduction in its taxable year ended February 4, 1954. Accordingly, respondent is sustained on this issue.

To reflect adjustments contained in the stipulation of the parties,

Decision will be entered under Rule 50.